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SUBJECT: FORMER SONATRACH COUNSEL CRITIQUES CHANGES TO
ALGERIA'S HYDROCARBON LAW

REF: A. ALGIERS 01595
[1](#)B. ALGIERS 01723

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[1](#)1. (SBU) SUMMARY: A former Sonatrach counsel provided us with a detailed briefing on the changes to Algeria's hydrocarbon legislation over the last 20 years and his views on the impact of the recent hydrocarbon amendments. He clarified that while the new amendments obligate the Algerian petroleum parastatal to take a majority stake in all upstream projects, Sonatrach will not be required to assume any risk in doing so. International oil companies will front all of the funds for exploration -- for which they will be reimbursed only if a discovery is made -- only to become a minority partner in successful new projects. He noted that foreign energy companies have always borne the risk of exploration, but ever since Algeria switched to a transparent bidding process in 2002 to attract more foreign investment, Sonatrach's participation has typically been 25 percent. Despite this disincentive, our contact stressed that foreign energy firms are likely to continue to invest and benefit from an enhanced regulatory environment and other positive fiscal provisions under the new law. He also voiced his concern about the impact on the evolution of Sonatrach, which he feared would have no incentive to invest in training and new technology. END SUMMARY

1986/1991 LEGISLATION GOVERNS ALL PROJECTS TO DATE

[1](#)2. (SBU) A former Sonatrach legal counsel explained to us September 28 how Algeria's 1986 hydrocarbon law was the first to open the country's oil and gas sector to foreign investment. Under the legislation, details regarding the payment of taxes and royalties, Sonatrach's participation, marketing agreements, and the other nuts and bolts of foreign participation were left to be negotiated as part of each individual contract, rather than mandated by law. Our contact underlined that the 1986 legislation had governed all of Algeria's foreign energy projects to date. (NOTE: The law was amended in 1991 to include provisions for foreign tax remuneration and recourse to international arbitration, among other minor modifications. A 2005 revision of the legislation, detailed below, was never implemented; hence there are no contracts in place subject to its conditions. END NOTE)

13. (SBU) The 1986 legislation gave international oil companies (IOCs) a menu of options for partnering with Sonatrach. Production sharing contracts (PSCs) were the most popular mechanism, accounting for some 90 percent of the agreements signed under the 1986 law, according to our contact. (NOTE: PSCs, which were first developed in Indonesia, seek to encourage investment by IOCs while allowing them to avoid the pitfalls of dealing with a host country's bureaucracy, such as its tax authorities and environmental regulators. Under a PSC, the foreign contractor typically bears all risk and costs for exploration, development and production. In return, if exploration is successful, the contractor receives a stipulated share of production; the IOC simply brings in a ship and takes its predesignated share of oil. These agreements work similarly for gas projects, with the notable exception that the contractor usually takes part in a joint marketing venture with the state. All ownership of energy-related infrastructure is retained by the host government. END NOTE) Under its PSCs, Sonatrach typically paid all royalties (calculated as a set percentage of a project's production value), taxes (calculated as a set percentage of a project's profits), and transportation fees. A close cousin of the PSC was the risk service contract (RSC), of which the former Sonatrach counsel explained there had been three. (NOTE: Risk service contracts are very similar to PSCs, with the exception that the foreign partner is contractually guaranteed a defined share of revenue rather than a share of production. END NOTE)

14. (SBU) Under the 1986 law, foreign firms could alternatively create joint ventures with Sonatrach, although our contact was not sure this had ever occurred. Finally, IOCs could form "participation in association" contracts, of which he estimated there had been no more than five. In

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these arrangements, IOCs would front all of the funds for exploration. In the case where exploration was successful, Sonatrach would reimburse them 51 percent. In turn, Sonatrach would receive 51 percent of the project's output and pay 51 percent of its royalties, taxes, and transportation fees. The former counsel stressed that of the four types of partnership allowable, only the "participation in association" and joint venture contracts obligated Sonatrach to hold a majority share.

15. (SBU) In 2002, Algeria held its first of six international oil and gas licensing rounds for unexplored blocks. Sonatrach had previously awarded foreign contracts for unexplored blocks by fiat, whereas a bidding system for already-developed blocks has existed since 1992. Energy Minister Khelil, when he was CEO of Sonatrach, established the international licensing round in an effort to attract foreign investment. The former counsel reiterated that in all of the projects signed as part of its licensing rounds, Sonatrach's participation was optional and based on the conditions of the particular contract. In practice, however, Sonatrach chose to participate in every contract by around 25 percent.

16. (SBU) Finally, our contact explained that contracts under the 1986 limitation have long been subject to profit-limiting price ceiling (or "ecrementage") clauses, which raise an IOC's taxes as the world oil price goes up. He confirmed that three major contracts signed in the late 1980s (ref A) are the exception. Following the conclusion of these deals, Sonatrach systematically included profit-limiters in its contracts. It did so up until 2000 with fixed ceilings and thereafter with a theoretically-similar but mathematically more complicated system known as "k factors."

2005 LEGISLATION: TOO GOOD TO BE TRUE

¶7. (SBU) The former Sonatrach counsel explained how the never-implemented 2005 hydrocarbon law would have obligated IOCs to have "concessionary" contracts. (NOTE: He remarked that while this was the industry term, Algerian officials shied from referring to these contracts as such to avoid the inevitable comparison with the historic western concessions in Iran and Saudi Arabia. END NOTE) Most importantly, the law codified the system of competitive bidding for awarding energy blocks and projects. Under the terms of the 2005 law, if Sonatrach bid for the project by itself and won, it could maintain 100-percent control. If an IOC won the bid, Sonatrach would have then had the choice to "back in" between 20 and 30 percent. Thus the winning IOC would have fronted the full costs of exploration. Had it proven successful, Sonatrach would have had 30 days from when the discovery was made to decide to reimburse the IOC between 20 and 30 percent of its investment. If, for example, Sonatrach had decided to "back in" 25 percent, it would have then received 25 percent of the project's output and have been required to pay 25 percent of the project's royalties, taxes, and transportation fees.

¶8. (SBU) The former counsel characterized the 2005 law as "excellent for Sonatrach and excellent for Algeria." He stressed that it would have liberalized Algeria's energy sector, forced Sonatrach to evolve into a commercially viable competitor to IOCs, and continued to offer the right incentives to foreign investors. He added that Khelil wanted IOCs to be able to hold 100-percent concessions, but political pressure had forced him to relent on the clause allowing Sonatrach to "back in" 20 to 30 percent. However, Khelil had scored a brief victory with pipeline projects, for which 100-percent foreign ownership over a 50-year concession would have been theoretically possible.

NEW AMENDMENTS MAINTAIN MANY POSITIVE ELEMENTS OF 2005 LAW

¶9. (SBU) The former Sonatrach counsel recounted what he viewed as a series of other positive changes in the 2005 law, all of which ultimately remained untouched with the 2006 amendments. He praised the establishment of Algeria's two new independent regulatory agencies, which he said would

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separate Sonatrach's conflicting roles as "judge and party." He highlighted the addition of retention clauses, which lengthen the period of IOCs' concessions between three and five years in order to give them time to build infrastructure and find markets for their oil and gas discoveries. Foreign participation in most downstream projects, he added, would be left alone. Finally, the law still included a series of financial measures that he assessed would benefit IOCs and promote greater investment. These included lowering royalty and taxation rates based on geographic area in order to promote the development of marginal fields; changes to an accounting measure known as "uplift" that offers IOCs advantages for amortization; additional tax exemptions; and the end of a requirement that IOCs pay Algerian social security for their non-Algerian workers.

¶10. (SBU) Our contact echoed Khelil in saying that much of the 2005 law and its amendments did not mark a change of policy so much as a codification into law of existing contractual practices (ref B). However, he critiqued both documents for being very poorly written. He highlighted various loose ends in the law, including rules pertaining to the domiciliation of IOCs in Algeria and the term of Sonatrach's participation in energy projects. He was skeptical that the coming implementing regulations would answer many of these questions. Yet there was a silver lining, he confessed: lawyers such as himself would have plenty to keep them busy.

¶11. (SBU) Our contact dismissed econoff's concern about a

vaguely worded provision in the amendments that would enable the Minister of Energy to abrogate the normal bidding process "for reasons of general interest in the context of hydrocarbon policies" with approval by the Council of Ministers (which is chaired by President Bouteflika). The former counsel assessed this less as a potential encroachment of the transparent bidding process by the presidency than a curb on the powers of the Minister of Energy. He viewed the clause as trying to rein in Khelil for seeking too much liberalization under the 2005 law. He noted that presidential approval is hardly uncommon in the Algerian energy sector. Each contract signed with an IOC, he said, has always required approval by the Council of Ministers.

WITH 2006 AMENDMENTS, "SONATRACH WILL SLEEP AGAIN"

112. (SBU) Under the 2006 legislation, our contact explained, all contracts would be structured exactly like the "participation in association" contracts practiced under the 1986 law. As a result, whereas Sonatrach would have had a choice to participate in upstream projects under the 2005 legislation, it will now be obligated to participate by a minimum of 51 percent. The same rule applies for pipeline and refinery projects; other downstream projects continue to be excluded. The former counsel warned that the new rules regarding upstream and pipeline contracts would give Sonatrach not only the majority of revenues, but also the majority vote for decisions regarding the projects. He viewed this as a disincentive to investment since foreign companies would bear the full risk of exploration only to be made a junior partner in successful projects. He emphasized that Sonatrach, with no incentive to invest in technology or training, will now "sleep again" as it goes forth and collects its 51 percent with no effort.

113. (SBU) Regarding the windfall profits tax, our contact said he understood the 5- to 50-percent production tax would apply to all previous contracts, not just those lacking "ecremage" clauses. (NOTE: Khelil hinted to Ambassador on September 23 that only contracts lacking profit-limiter clauses would be impacted by the windfall profits tax, but he did not address the issue definitively. END NOTE) He said he expected this tax to be assessed on a graduated basis. For example, the tax would be 5 percent when oil cost USD 30-35 per barrel, 10 percent when oil cost USD 35-40 per barrel, etc. He interpreted the law as indicating that the windfall profit tax would apply only to existing contracts, since Sonatrach was already likely to demand similar provisions in future deals. He added that a major problem

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presented by the windfall tax was that the law was based upon the fixed amount of USD 30 per barrel, rather than an indexed figure. Thus over time, inflation alone would contribute to the amount of revenue subject to taxation.

COMMENT

114. (SBU) The former Sonatrach counsel's analysis of the evolution of Algeria's hydrocarbon regime suggests that the 2006 amendments may prove more detrimental to the evolution of Sonatrach than to foreign investment in Algeria. The windfall profits tax, he confirmed, should significantly impact only a handful of early projects, since all subsequent deals contained profit-limitation clauses. (He seemed to gloss over the fact that the affected contracts, such as Anadarko's, not only account for some of the largest investment in Algeria's hydrocarbon sector, but also came at a time when few other investors were willing to brave doing business in Algeria.) That being said, while there is no doubt that the 2005 law in its original form would have offered IOCs a better deal than the current amendments allow, our contact seemed to view the sectoral reorganization and enhanced regulatory environment as outweighing the

amendments' negative fiscal provisions. In this sense, he echoed Minister Khelil's rationalization that since oil companies are making enormous profits in Algeria, they are unlikely to stop investing here any time soon. Once the implementing regulations are available, IOCs need only plug the new numbers into their algorithms to determine whether or not prospective projects will be profitable. What is not as easy to quantify is how this clumsily written legislation will hinder foreign investment by contributing to Algeria's already formidable red tape.

¶15. (SBU) In addition to the Ambassador's meeting with Minister of Energy Khelil, on September 17 we raised our concerns about the sanctity of existing contracts with former finance minister and current MP Abdelkrim Harchaoui. Harchaoui suggested that the tax implications of the forthcoming implementing regulations (which Bouteflika has already signed, closing the window on any negotiation for the time being) will not be as severe as the international business press has warned. The former Sonatrach counsel agreed to brief us on the ramifications of these regulations once they are published.

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